

Sole trader and partnership financial statements

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Presentation outline

- Sole trader financial statements
- Conversion of a sole trader to a company
- Sale of a sole trader's business to a company
- Partnerships
- Preparing partnership accounts
- Accounting for changes in partnership structure
- Conversion or sale of a partnership to a company

Financial statements of Sole Trader ship business

In terminology sole trader financial statements are very similar to a profit and loss account and balance sheet prepared under Non-IAS for a company where they differ is in relation to:

- **Tax**
- **The format of the profit and loss account**
- **The ownership interests.**

Ownership interests

Opening capital = net assets at start of period

Add.: Capital introduced in the period

Add.:(Less): Net profit/net loss of the period

Less: Drawings (of cash, or of inventory at cost)

Closing capital = net assets at end of period

Conversion of a sole trader to a company

When a sole trader converts the business to a company or registers it, the sole trader's ledger accounts must be closed and the new company's opened up.

To close the sole trader's accounts following accounts are used:

- **Revaluation account**
- **Realization account and**
- **Capital account .**

Contd....

In the new company's accounts, unless the net assets are taken over at values which exactly reflect the value of the shares issued, an account for purchased goodwill is needed.

Why would a sole trader wish to register as a limited liability company?

- To gain the protection of limited liability for the sole trader, so that he/she is no longer personally liable for the business's debts
- To make raising of capital easier, as any new investors will receive shares in the business
- To take advantage of certain tax concessions for companies
- To appear more established in the eyes of the world.

Accounting for a registered joint stock company

Registration under Companies Act 1994 means that a new entity, a company, comes into being, so:

There is no longer any need for any of the ledger accounts that the sole trader has been maintaining, so far: the sole trader accounts are closed down

New ledger accounts are needed for the new company

Closing down the sole trader's accounts

The procedure is as follows:

Make revaluation adjustments in the sole trader ledger accounts so that the net assets are stated at the value represented by the shares being issued:

DEBIT	-	Asset accounts	TK.	X
CREDIT	-	Revaluation account	TK.	X
DEBIT	-	Revaluation account	TK.	X
CREDIT	-	Liability accounts	TK.	X

Contd...

The balance on the revaluation account is the surplus or deficit on revaluation of the business. This is transferred to the capital account:

DEBIT	-	Revaluation account	TK.	X
CREDIT	-	Capital account	TK.	X

Clear all ledger accounts, excluding the capital account, to a realisation account. Enter the shares issued in consideration to the remaining two accounts:

DEBIT	-	Capital account	TK.	X
CREDIT	-	Realisation account	TK.	X

Opening up the new company's account:

A new set of ledger accounts for the company is set up, and entered with:

- The shares issued

- The assets and liabilities acquired

It is at this point that the company as a new entity could attribute different valuations to assets and liabilities acquired. If the consideration paid exceeds the value the company puts on the net assets acquired, the difference is debited to purchased goodwill..

Sale of a sole trader's business to a company

A sole trader may sell the business to a third party, usually a company. As with conversion to a limited company the sole trader's accounts are closed down and then the net assets, including goodwill, are introduced to the acquiring company.

Partnership

A partnership is an arrangement between two or more individuals in which they share the risks and rewards of a joint business operation, as if they were joint sole traders.

The partnership agreement

A partnership agreement contains the terms of the partnership, in particular the financial arrangements between partners and how profit/loss should be appropriated. It should cover the following issues.

- **Capital**
- **Interest on capital**
- **Partners' salaries**
- **Profit-sharing ratio (PSR)**
- **Guaranteed minimum profit shares**
- **Drawings**

Agreement set down in the Partnership Act 1932

If there is no formal agreement between the partners, certain rules laid down by the Partnership Act 1932 are presumed to apply instead.

- Profits are shared equally between the partners
- There are no partners' salaries
- Partners receive no interest on the capital they subscribe to the business and pay no interest on drawings.
- Partners are entitled to interest of 6% per annum on any amounts they advance to the business in excess of subscribed capital, such as a loan.

Appropriating partnership profit

The partnership's net profit is calculated in the same way as for a sole trader using a profit and loss account, or the ETB. We then prepare an appropriation statement, which

Allocates interest on capital, interest on drawings, and salaries to each partner

Shares out the residual profit in the PSR

Preparing partnership accounts

Each partner's interest in the partnership is shown in a capital account and a current account.

If a partner has made a loan to the partnership, this is treated as a third party loan, with interest deducted from net profit. It may be credited to the partner's current account rather than being paid in cash.

A profit appropriation statement is used as a working to appropriate salaries, interest on capital, interest on drawings and residual profit share to each partner.

How does accounting for partnerships differ from accounting for sole traders?

Partnership accounts are identical in many respects to the accounts of sole traders.

Assets and liabilities are like the net assets of any other business, and are accounted for in the same way. Even where a loan to a partnership comes from a partner, this is accounted for as if it were a third party loan, in the top half of the balance sheet.

Net profit is calculated in the same way as the net profit of a sole trader. If a partner makes a loan to the business (as distinct from a capital contribution) then interest on the loan is an expense in the profit and loss account, in the same way as interest on any other loan from a third party.

Just like a sole trader tax does not appear in partnership accounts

How does accounting for partnerships differ from accounting for sole traders?

Partnership accounts are identical in many respects to the accounts of sole traders.

- Assets and liabilities accounting
- Net profit calculation
- Income Tax

There are two respects in which partnership accounts are different, however.

The ownership interest of each partner must be shown.

The net profit must be appropriated between the partners and shown in the accounts.

Appropriation of profit: Sharing out profits in accordance with the partnership agreement.

Accounting for each partner's ownership interest

Initial capital contributions are recorded in capital accounts for each partner. (Since each Partner is ultimately entitled to repayment of capital it is clearly vital to keep a record of how much is owed to whom.)

Profits and losses appropriated over time, less drawings, are shown in current accounts for each partner.

Current account: A record of the profits retained in the business by Partner

Differences between capital and current accounts are as follows.

The balance on the capital account remains static from year to year.

The current account is continually fluctuating up and down, as the partnership makes profits and losses which are shared out between the partners, and as each partner takes out drawings.

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If the partnership agreement provides for interest on capital, partners receive interest their on the balance in capital account, but not on the balance on their current account.

If the amount of a Partner's drawings exceeds the balance on his/her current account, the current account will show a debit balance brought forward at the beginning of the next period.

The ownership interest side of the partnership balance sheet will therefore consist of:

Capital accounts for each partner.

Current accounts for each partner.

Accounting for loans by partners

A partner making a loan to the partnership becomes its creditor. On the balance sheet the loan is shown separately as a long-term liability (unless repayable within twelve months, in which case it is a current liability)' interest on the loan is a deduction from profit, not an appropriation. According to the Partnership Act 1932 interest is payable at 6% if there is no agreement to the contrary.

Interest on partners' loans is usually credited to the partner's current account as this is administratively more convenient, especially when the partner does not particularly want to be paid the loan interest; in cash immediately it becomes due.

Accounting for appropriation of net profit/loss

The net profit of a partnership is shared out in the PSR in an appropriation account, which follows on from the profit and loss ledger account itself.

The accounting entries for an individual share of profits for each partner are:

DEBIT	P & L ledger account with net profit c/d
CREDIT	P & L appropriation account with net profit b/d

DEBIT	P & L appropriation account
CREDIT	The current accounts of each partner

The steps

Step-1: Establish the net profit, after deducting interest on loans from partners.

Step-2: Appropriate interest on capital and salaries first. These items are appropriations of profit and do not appear in the P&L account.

Step-3: Charge partners interest on their drawings where relevant.

Step-4: Residual profits are shared out between partners in the PSR.

Step-5: Each partner's share of profits is credited to his/her current account.

Partnership accounts on the ETB

The ETB can be used to help prepare partnership accounts. The differences to sole trader ETBs are as follows:

Accrued interest on a Partner's loan is accounted for in the adjustments column and included in the cross-casts, so the net Profit figure in the debit column of the profit and loss account is then the amount to be appropriated

DEBIT	Interest expense	TK.	X
CREDIT	Current account	TK.	X

Contd....

Each Partner's drawings are transferred in the adjustments columns from the drawings accounts to the current account

DEBIT	Current accounts	TK.	X
CREDIT	Drawings accounts	TK.	X

The profit appropriation statement is prepared as a separate working, then each partner's total profit share is accounted for as follows

DEBIT	Profit and loss account	TK.	X
CREDIT	Current accounts (balance sheet)	TK.	X

Accounting for changes in partnership structure

When a partner dies or retires, the remaining parties normally carry on the business, buying out the departing partner's share of the net assets, including goodwill.

Retirement or death of a partner

Any changes in a partnership require a new agreement. Unless the agreement specifically states otherwise, legally the old partnership is dissolved and a new partnership is created. However, from an accounting viewpoint, it is more realistic to treat the partnership as continuing but with a change in the Partners and the PSR.

On the retirement or death of a partner, we need to:

Calculate the profits up to the date of change and allocate them according to the old PSR.

Allocate the profits after the date of change according to the new PSR

Goodwill in the partnership accounts

Usually on a Partner's retirement or death a valuation of the partnership's net assets is carried out or the partners simply agree that as well as a share of the profits to the date of retirement the retiring partner should also take a share in the partnership's goodwill, in the form of a settlement in cash or other assets from the other partners. Once the partner has gone the goodwill is then removed from the accounts.

The principles behind how we account for retirement or death of a partner when there is a settlement which includes recognition of the value of the partnership's goodwill are the same as we used when converting and selling a sole trader's business.

Admission of a Partner

When a new partner is admitted, a new agreement is needed to cover the appropriation of profits.

If the new partner introduces additional capital into the partnership, the total amount they bring in must be credited to their capital account.

Conversion or sale of a Partnership to a company

The same accounting principles apply when the partnership is sold to a company, or converts to being a company, as we saw in relation to a sole trader:

Close down the partnership ledger account.

Open up the new company's ledger accounts or take the partnership's net assets into an existing company's books at the valuation it chooses to attribute to them.

Regarding the purchase consideration, shares in the company and/or cash are allocated to each Partner in line with their interest in the business, uplifted if desired by a revaluation

Answer the following questions

1. A B and C are in partnership with a profit sharing ratio of 3:2: 1. For the year ended 31.12.X9, the partnership profits are TK. 18,000. What is B's share of the profits?

- A. TK. 3,000
- B. TK. 6,000
- C. Tk. 9,000
- D. TK.18,000

Answer - B

Contd....

2. Madro had net assets of TK.35,000 at 1 January 20X8, and these grew by TK.22,500 in the year. He took drawings of TK. 14,000 and made a net profit of TK. 23,900. How much capital did Madro inject in the year?

- A. Tk. 9,900
- B. TK. 12,600
- C. Tk. 67,400
- D. TK.102,400

Answer - B

Contd....

3. Serko made a net profit of TK.50,000 as a sole trader in 20X7. He has calculated that tax at 25% is due on this amount. What is the tax charge in Serko's profit and loss account?

Answer - Tk. 0.

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4. Upto has net assets of TK.68,000 on 31 December 20X1, when he decides to incorporate the business. He wishes to revalue his fixed assets by TK.30,000, and write off debtors of TK.6,000. How many TK. 1 shares issued at par should upto Ltd issue?

Answer – Tk. 92,000

Contd....

5. Having paid cash of TK.50,000 and issued 60,000 50p shares at a price of TK. 1.25 for the net assets of Babto's business, Ahern Ltd shows these net assets at TK.72,000 in its ledger accounts. How much will it debit to purchased goodwill.

Answer – Tk. 53,000

Contd....

6. In the absence of a written agreement a partner's loan to the partnership attracts annual interest at:

- A. 3%
- B. 4%
- C. 5%
- D. 6%

Answer – D.

Contd....

7. Pam's capital account is TK. 10,000 at the end of 20X3, and her partner Mike's is TK.20,000. Their current accounts are TK.27,820 and TK. 16,910 respectively. In 20X3 the partnership made a net profit of TK.42,300. What are its net assets at the end of 20X3?

Answer - Tk. 74,730

Contd....

8. Rene, Hughie and Paul are partners sharing profit 4:3:1. Paul gets a salary of TK. 12,000. Hughie retires 3 months into 20X4. in 20X4 a profit of TK.67,040 is made. How much profit is appropriated to Hughie when he retires?

Answer – Tk. 5,160

Contd....

9. When Malco sells his business to Rombo Ltd, his net assets are TK.108,000. He takes over cash of TK. 15,000 and a fixed asset with a net book value of TK.23,000. There is a surplus on revaluation of the other assets of TK.30,000. How much does Malco receive as consideration for his business?

Answer – TK 100,000

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10. Sarah has a minimum profit share of TK. 10,000 guaranteed by Richard. On initial appropriation Sarah is allocated TK.8,000 and Richard is allocated TK. 16,000. What is Richard's final appropriation of profit?

Answer – 14,000.

